The Federal Reserve Board

Minutes of the Federal Open Market Committee
June 29-30, 2005

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, June 29, 2005 at 2:00 p.m. and continued on Thursday, June 30, 2005 at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. Geithner, Vice Chairman
Ms. Bies
Mr. Ferguson
Mr. Fisher
Mr. Gramlich
Mr. Kohn
Mr. Moskow
Mr. Olson
Mr. Santomero
Mr. Stern

Ms. Cumming, Messrs. Guynn and Lacker, Mses. Pianalto and Yellen, Alternate Members of the Federal Open Market Committee

Mr. Hoenig, Ms. Minehan, and Mr. Poole, Presidents of the Federal Reserve Banks of Kansas City, Boston, and St. Louis, respectively

Mr. Reinhart, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Ms. Johnson, Economist
Mr. Stockton, Economist

Messrs. Evans, Freeman, and Madigan, Ms. Mester, Messrs. Oliner, Rolnick, Rosenblum, Tracy, and Wilcox, Associate Economists

Mr. Kos, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Kamin, Slifman, and Struckmeyer, Associate Directors, Divisions of International Finance, Research and Statistics, and Research and Statistics, respectively, Board of Governors

Messrs. Clouse, Wascher, and Whitesell, Deputy Associate Directors, Divisions of Monetary Affairs, Research and Statistics, and Monetary Affairs, respectively, Board of Governors

Messrs. English, Leahy, and Treacy[1], Assistant Directors, Divisions of Monetary Affairs, International Finance, and Banking Supervision and Regulation, respectively, Board of Governors

Mr. Simpson, Senior Adviser, Division of Research and Statistics, Board of Governors

Mr. Skidmore, Special Assistant to the Board, Office of Board Members, Board of Governors

Mr. Small, Project Manager, Division of Monetary Affairs, Board of Governors

Mr. Wright[2], Section Chief, Division of Monetary Affairs, Board of Governors

Messrs. Bowman[2], Gallin[1], and Lehnert[1], Senior Economists, Divisions of International Finance, Research and Statistics, and Research and Statistics, respectively, Board of Governors

Messrs. Doyle[1] and Martin[1], Economists, Division of International Finance, Board of Governors

Messrs. Kumasaka[1] and Luecke, Senior Financial Analysts, Division of Monetary Affairs, Board of Governors

Ms. Low, Open Market Secretariat Specialist, Division of Monetary Affairs, Board of Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Eisenbeis and Judd, Executive Vice Presidents, Federal Reserve Banks of Atlanta and San Francisco, respectively

Messrs. Fuhrer, Goodfriend, and Hakkio, Ms. Perelmuter, Messrs. Rasche, Rudebusch[1], Sniderman, and Williams[1], Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Kansas City, New York, St. Louis, San Francisco, Cleveland, and San Francisco, respectively

Mr. Peach[1], Vice President, Federal Reserve Bank of New York

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By unanimous vote, the Federal Open Market Committee approved the selection of Richard T. Freeman to serve as associate economist of the Committee until the selection of a successor at the first regularly scheduled meeting after December 31, 2005.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no open market operations in foreign currencies for the System's account in the period since the previous meeting. The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period since the previous meeting. By unanimous vote, the Committee ratified these transactions.

At this meeting the Committee reviewed and discussed staff presentations on the topic of housing valuations and monetary policy. Prices of houses in the United States had risen sharply in recent years, especially in certain areas of the country, to very high levels relative to incomes or rents. In addition to local market factors, a wide range of influences appeared to be supporting home prices, including solid gains in disposable income, low mortgage rates, and financial innovation in the residential mortgage market. Prices might be somewhat above the levels consistent with these underlying factors, but measuring the extent of any overvaluation either nationally or in regional markets posed considerable conceptual and statistical difficulties. Meeting participants noted that the rise in house prices had been accompanied by a modest shift toward potentially riskier types of mortgages, including adjustable-rate and interest-only loans, which could pose challenges to both lenders and borrowers. Nonetheless, financial institutions generally remained in a comfortable capital position, such loans had performed well thus far, much of the associated risk had been transferred to other investors through securitization, and valuations had risen more rapidly than mortgage debt on average--so that loan-to-value ratios had fallen.

The information received at this meeting suggested that the economy was expanding at a moderate pace in the second quarter. Housing activity remained at a high level, business investment appeared to have improved some after a slowdown of growth in the first quarter, and manufacturing picked up notably in May. Supported by a rebound in motor vehicle purchases, consumer spending appeared on track to post another moderate gain for the quarter. Labor demand continued to expand, and the unemployment rate edged down further in May. Core CPI inflation slowed in April and May, but crude oil prices turned higher again following a decline earlier in the spring.

Averaging through a large gain in April and a more modest increase in May, growth in payroll employment was on par with that over the preceding six months. Payrolls expanded in line with their recent trends in the construction, transportation and utilities, and nonbusiness services sectors, while hiring in financial services slowed a bit, and the manufacturing sector posted further small losses of jobs. The average workweek of production or nonsupervisory workers edged up over the two-month period, helping to boost aggregate hours to the highest level since early 2001. The unemployment rate dipped to 5.1 percent in May. Meanwhile, the labor force participation rate moved up a bit, suggesting that the labor market had strengthened enough to attract some individuals back into the workforce. Survey indicators and the continued relatively low level of initial claims for unemployment insurance also supported the notion of continued improvement in the labor market.

Industrial production declined in April, owing to a dip in utilities output, but widespread gains in manufacturing output in May offset that loss. On net, industrial production was little changed over April and May; capacity utilization generally followed the same pattern as output.

Real personal consumption expenditures appeared to be increasing at a moderate pace this quarter, though a bit below that of the first quarter. Purchases of motor vehicles rebounded smartly after declining in the first quarter. Excluding motor vehicles, however, the expansion of real consumer outlays likely slowed of late, against a backdrop of modest gains in real income. Recent measures of consumer confidence improved from their levels earlier in the spring, when higher gasoline prices and concerns about a slowing in the pace of the economic expansion may have served as restraining influences.

Activity in the housing sector remained robust. Single-family starts averaged more than 1.65 million units at an annual rate in April and May, not much below the very strong first-quarter pace. Sales of both new and existing homes remained at a high level in May. While prices of existing homes continued to increase rapidly, new home prices showed signs of decelerating. Available indicators suggested that, with the ongoing support of low mortgage rates, the housing sector remained strong in June.

Spending on equipment and software registered a solid increase in the first quarter, and the available data suggested that second-quarter spending was continuing at a slightly faster pace. Shipments of nondefense capital goods posted sizable increases in recent months, although gains in orders were more uneven. Broadly speaking, the fundamentals continued to support business investment, with the user cost of capital still low and corporate balance sheets healthy. Outlays for construction of nonresidential structures appeared to have picked up some, but the level of such investment remained subdued. And although spending on commercial structures had moved up in recent months, outlays for office buildings were still at depressed levels, and expenditures on manufacturing and other facilities were lackluster.

The book value of manufacturing and trade inventories continued to grow in April, but more slowly than in the first quarter. With these increases, the inventory-sales ratio fell back in April after moving up a little in the first quarter.

After reaching a record high relative to GDP in February, the U.S. international trade deficit narrowed in March, but widened again in April. While the value of exports of goods and services increased in both months, the value of imports of goods and services jumped in April, more than offsetting a decline in March. GDP growth in most major foreign industrial economies picked up slightly in the first quarter, but recent economic indicators for the major foreign economies in the second quarter were mixed.

Consumer prices were about unchanged in May after posting large increases in the previous few months. Consumer energy prices, in particular, reversed part of their earlier run-up. Excluding food and energy, inflation appeared to have moderated slightly from its pace in the early part of the year. Despite this moderation, measures of core consumer price inflation over the past year were somewhat above those for the comparable period a year ago. The producer price index rose sharply in April, but dropped back again in May, driven largely by a swing in the food and energy components. According to recent surveys, both near-term and longer-term inflation expectations had changed little over the past two months, and market measures of inflation compensation had moved lower. With regard to labor costs, growth in hourly compensation in the nonfarm business sector in the first quarter was estimated to have slowed some after advancing notably in the fourth quarter; the first quarter increase was broadly similar to those posted during the middle of last year.

At its May meeting, the Federal Open Market Committee decided to increase the target level of the federal funds rate 25 basis points, to 3 percent. In its accompanying statement, the Committee expressed its perception that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. The Committee also noted that recent data suggested that the solid pace of spending growth had slowed somewhat, partly in response to the earlier increases in energy prices, but that labor market conditions apparently continued to improve gradually. While pressures on inflation had picked up in recent months and pricing power was more evident, longer-term inflation expectations remained well contained. In these circumstances, the Committee believed that policy accommodation could be removed at a pace that would likely be measured but noted that it would respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability.

The decision at the May FOMC meeting to raise the federal funds rate target 25 basis points, to 3 percent, to maintain an assessment that risks to the goals of price stability and sustained growth were balanced, and to retain the "measured pace" language was widely expected in financial markets. The publication of the minutes three weeks later also contained few surprises for investors and elicited little market reaction. Market expectations for the future path of policy ended the period higher in the near term but lower at longer horizons. Nominal Treasury yields followed the shift in policy expectations, with near-term yields higher and longer-term yields modestly lower, on net. Spreads on investment-grade corporate bonds were little changed over the intermeeting period, but spreads on speculative-grade bonds contracted notably. Buoyed by the drop in longer-term interest rates and largely upbeat economic news, major equity indexes rose appreciably over the intermeeting period. The positive economic data also seemed to lift the dollar against major foreign currencies, though the dollar's moves against individual currencies varied widely.

M2 edged lower over April and May as the opportunity cost of holding M2 assets rose further. Liquid deposits were especially weak, owing to the slow adjustment of yields paid on these deposits to increases in market rates. Despite the recent softness in M2, its velocity remained quite low relative to its historical relationships with opportunity cost. Bank credit decelerated sharply in April and May from rapid gains posted in the first quarter, as growth in both securities and loans fell.

In the staff forecast prepared for this meeting, the economy was seen as likely to expand this year and next at a rate just above its potential. The effects of reduced monetary and fiscal policy stimulus were expected to be counterbalanced by continued low long-term interest rates and an abatement of energy-related headwinds. Household spending was expected to firm going forward as real income posts solid gains attributable in part to the ongoing improvement in the labor market. Business investment was projected to benefit from the combination of favorable prospects for sales, supportive financial markets, and the ongoing need to replace or upgrade aging equipment and software. A slightly larger portion of domestic demand was expected to be supplied by imports over the forecast period. The forecast for consumer price inflation was revised up, with inflation seen as somewhat higher this year than in 2004, reflecting in part higher import prices and the direct and indirect effects of higher energy prices, and only edging lower next year as these price pressures wane.

In their discussion of current conditions and the economic outlook, many meeting participants noted that incoming data had been reassuring about the strength of the expansion. Following some softer readings earlier in the year, incoming spending and production data over the intermeeting period indicated that the expansion remained firm, led by residential and business investment. In addition, labor market conditions continued to strengthen gradually. The economy evidently had been resilient in the face of rising energy prices, and financial conditions remained accommodative, supporting growth going forward. Increases in core consumer prices had slowed of late, though underlying inflation was still seen by most meeting participants as likely to be modestly higher this year than last, impelled in part by the pass-through of a further rise in energy prices. However, the impetus to inflation from the prices of oil and other commodities was expected to wane, and long-term inflation expectations apparently remained well-anchored. With some limited remaining slack in labor markets likely damping growth in compensation, as well as further withdrawal of policy accommodation, core inflation was expected to remain contained.

In preparation for the Federal Reserve's semiannual report to the Congress on monetary policy, the members of the Board of Governors and the presidents of the Federal Reserve Banks submitted individual projections of the growth of GDP, the rate of unemployment, and core consumer price inflation for 2005 and 2006. The forecasts of the rate of expansion in real GDP were concentrated in the upper part of a 3 to 3-3/4 percent range for 2005, and the forecasts for 2006 were concentrated at the lower end of a range of 3-1/4 to 3-3/4 percent. These rates of growth were associated with a civilian unemployment rate of 5 to 5-1/4 percent in the fourth quarter of this year and a rate of 5 percent in the fourth quarter of 2006. Forecasts of the rate of inflation, as measured by the core PCE price index, were mainly near the middle of a 1-1/2 to 2-1/4 percent range this year and somewhat below the middle of a range of 1-1/2 to 2-1/2 percent next year.

In their comments about developments in key sectors of the economy, meeting participants noted that the fundamentals underlying household spending remained firm. With rising home and equity prices buoying household wealth, consumer expenditures continued to advance. Although the recent surge in energy prices was anticipated to impose some drag for a time, consumption spending was expected to grow about in line with income going forward, in an environment of further gradual improvements in labor markets. Increased speculative activity in housing markets was evident in some parts of the country, but robust demand for new homes owed in large part to the ongoing economic expansion and low long-term interest rates.

Business outlays for capital goods continued to rise, and the outlook for investment spending remained solid, supported by increased sales, low interest rates, robust profits, and strong business balance sheets. Anecdotal reports from industry contacts generally pointed to planned increases in investment spending, though in some regions businesses apparently remained cautious about the outlook. Conditions in the commercial real estate sector, which had been weak for some time, were said to have improved in some parts of the nation.

Several meeting participants expressed some concern about domestic and global imbalances. Large federal budget deficits were expected to persist despite an increase in tax receipts in recent months. These deficits were contributing to a low level of national saving that would, if not corrected over time, ultimately constrain investment and overall economic growth. Moreover, U.S. trade deficits were expected to remain large going forward, reflecting both the low level of U.S. saving and relatively slow growth in some of our trading partners. Uncertainties regarding the nature and timing of the potential correction of these imbalances complicated the assessment of the intermediate-term prospects for the U.S. economy.

In their discussion of developments in asset markets, the participants' comments focused on two related issues: the low level of long-term interest rates and the continued run-up in home prices. Despite substantial cumulative policy tightening over the past year, long-term Treasury yields had moved considerably lower, implying a significant flattening of the yield curve (measured as the spread between long-term and short-term Treasury yields). Lower compensation for inflation accounted for a portion of the decline in longer-term nominal yields, but a larger portion reflected reductions in real yields. Participants cited a variety of factors as possibly contributing to the unusual behavior of long-term rates over this period. For one, investors might have marked down the level of real interest rates seen as likely to be necessary to contain inflation and keep output in line with potential--perhaps reflecting weak investment demand abroad relative to saving--or even might have come to expect a stretch of sub-par U.S. growth. However, anticipation of slow growth seemed inconsistent with higher stock prices and thin risk spreads in corporate debt markets. The behavior of long-term interest rates could also reflect reduced uncertainty on the part of investors about the economic outlook -- as seen in low readings of implied volatility in bond and equity markets. Finally, demands for longer-term U.S. securities by both domestic and foreign investors might have been boosted by special factors. Confidence about the economic outlook and low market interest rates--along with possibly outsized expectations of capital gains in some markets--could also help to account for the high level of home prices the Committee had discussed on the first day of the meeting. It was agreed that considerable uncertainty attended the outlook for both long-term interest rates and home prices.

With regard to any role for monetary policy in responding to possible imbalances in housing or bond markets, meeting participants stressed the importance of the pursuit of their core objectives of price stability and maximum sustainable economic growth. To the extent that an asset price movement threatened the achievement of those objectives, it would of course be taken into consideration in setting policy. However, given the unavoidable uncertainties associated with judgments regarding the appropriate level of and likely future movements in asset prices, a strategy of responding more directly to possible mispricing was seen as very unlikely to contribute, on balance, to the achievement of the Committee's objectives over time.

Participants' views on the inflation outlook were mixed. Thus far in 2005, core consumer price inflation had been higher than most participants had expected at the start of the year, reflecting, at least in part, the pass-through effects of higher energy, commodity, and import prices. While such shocks could be expected to boost inflation temporarily, some participants expressed concern that, with policy still accommodative, the underlying pace of inflation might be in the process of stepping up, perhaps to a level that was at the upper end of the range that they viewed as compatible with the Committee's price stability objective. The degree of slack remaining in labor and resource markets was very uncertain, and unit labor costs in the nonfarm business sector had moved notably higher in recent quarters. Trend unit labor costs could also be boosted by slower growth in structural productivity; while recent evidence was not conclusive, some participants thought the underlying pace of productivity growth might well fall back in coming quarters following the substantial gains seen in recent years. And with higher energy prices already eating into profit margins at firms outside the energy sector, increases in unit labor costs might be more likely to be passed through into prices.

While agreeing that inflation developments had to be watched carefully, other meeting participants emphasized that recent core inflation data had been relatively restrained, and anecdotal reports suggested that pricing power at many firms remained quite limited. Moreover, readings from futures markets suggested that oil prices would likely flatten out, so their effect on inflation should gradually ebb. Similarly, prices of other commodities and imports, which had surged for a time, were now moderating. Survey and market measures of long-term inflation expectations did not suggest that the earlier higher inflation readings were going to persist. Finally, while the degree of slack in labor markets was uncertain, total labor compensation had probably been boosted temporarily around the turn of the year by special factors, and the recent behavior of a range of other indicators of labor costs appeared consistent with some remaining slack that would likely tend to restrain inflation pressures. Moreover, anecdotal reports of labor market conditions continued to point to shortages of labor only for certain, mostly skilled, occupations.

In the Committee's discussion of monetary policy for this meeting, all members agreed on a 25 basis point increase in the target federal funds rate to 3-1/4 percent. Economic growth remained firm, while rising energy, and possibly labor, costs threatened to put upward pressure on inflation. Even with this action, the federal funds rate remained below the level members anticipated would prove necessary in the long run to contain inflation pressures and keep output near potential. However, the pace and extent of future policy moves would depend on incoming data.

In considering the statement to be released following this meeting, members concurred that it should note that even with the rise in oil prices, the expansion remained firm and labor markets continued to improve gradually. All also thought that the statement should note the continued pressures on inflation, while mentioning that long-term inflation expectations remained well contained. With policy still seen as accommodative, members agreed that the statement should retain an assessment that the risks to both sustainable economic growth and price stability were balanced, conditional on appropriate policy action. Members also agreed that the statement language indicating that "policy accommodation can be removed at a pace that is likely to be measured" correctly characterized the outlook for policy for now. The members concurred that at this stage in the expansion, with margins of slack resources narrowing and inflation somewhat higher, the Committee needed to be particularly alert to signs of a further increase in inflation. Such an increase could be particularly problematic because it might impart upward momentum to inflation expectations that would be costly to reverse. In any case, additional tightening would probably be necessary, but views differed on the amount of tightening that would likely be required to keep inflation contained and bring output in line with potential. However, members agreed that there was no need to make such an assessment at this time, and that the appropriate pace and degree of cumulative policy adjustment would depend on economic developments going forward. With the forward-looking language in the statement clearly conditioned on the outlook, it was not seen as limiting the Committee's flexibility in responding to such developments.

At the conclusion of the discussion, the Committee voted to authorize and direct the Federal Reserve Bank of New York, until it was instructed otherwise, to execute transactions in the System Account in accordance with the following domestic policy directive:

"The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. To further its long-run objectives, the Committee in the immediate future seeks conditions in reserve markets consistent with increasing the federal funds rate to an average of around 3-1/4 percent."

The vote encompassed approval of the paragraph below for inclusion in the statement
to be released shortly after the meeting:
"The Committee perceives that, with appropriate monetary policy action, the upside and downside risks to the attainment of both sustainable growth and price stability should be kept roughly equal. With underlying inflation expected to be contained, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured. Nonetheless, the Committee will respond to changes in economic prospects as needed to fulfill its obligation to maintain price stability."

Votes for this action: Messrs. Greenspan and Geithner, Ms. Bies, Messrs. Ferguson, Fisher, Gramlich, Kohn, Moskow, Olson, Santomero, and Stern.

Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 9, 2005.

The meeting adjourned at 1:25 p.m.

Notation Vote
By notation vote completed on May 23, 2005, the Committee unanimously approved the minutes of the meeting of the Federal Open Market Committee held on May 3, 2005.

Vincent R. Reinhart
Secretary

Footnote

1. Attended Wednesday's portion of the meeting. Return to text

2. Attended Thursday's portion of the meeting. Return to text

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